The Other Deficit—
the International One—and How to Shrink It
by Kent H. Hughes

SUMMARY

U.S. private and public debt to foreigners, including foreign governments, is enormous and still growing. The debt is damaging the U.S. economy and the country’s stature as a world leader. Reducing this debt will require public action to restrain the fiscal deficit and bolster private savings and trade. Ultimately, adopting a national growth and innovation strategy would highlight key economic sectors for balancing international flows of goods, services, and capital.

America may have the world’s richest, largest economy, but since the 1980s it has been increasingly in debt. By 2006, the United States was borrowing more than $800 billion—about 6 percent of its gross domestic product—per year. The beginnings of the financial crisis in 2007 slowed but did not eliminate the borrowing.

The U.S. current account, which sums up both private and government international payments, went into deficit in 1982. By 2008, the cumulative U.S. current account deficit exceeded $7.3 trillion. By June 2013, overseas investors held more than $5.6 trillion in U.S. Treasury securities—roughly 47 percent of the total held by the public. China alone holds
more than $1.2 trillion, and Japan holds over $1 trillion. Even with record-low interest rates, every year the U.S. government sends well over $100 billion overseas in interest payments. With more normal interest rates, those figures could triple.

**The use and abuse of borrowing**

Borrowed money can, of course, be put to good use. Companies borrow to invest in new equipment, undertake research and development, and build their national and international markets. The return on the investment can pay back the borrowed capital, with added profits available for future investment or increased dividends. Countries can benefit from borrowing, too, as the United States did in the 1800s when it borrowed from Europe to help establish a strong industrial base.

America’s recent borrowing, however, has been used to offset its fiscal deficits and a declining level of overall saving. Instead of supporting income-generating investments, too much money flowed into everyday consumption and housing.

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**How our borrowing hurts U.S., here and abroad**

Just as rising demand for any good increases its price, overseas demand for U.S. debt bids up the value of the dollar. This lowers the cost of imports to the United States and raises the cost of U.S. exports overseas. Other countries, hoping to improve the position of their own exports in U.S. markets, exacerbate that price advantage by further lowering the value of their own currency relative to the dollar. This imbalance promotes U.S. trade deficits and has contributed to the loss of more than 60,000 manufacturing plants and 5 million manufacturing jobs over the past decade. Despite a recent modest recovery in manufacturing, which has added roughly 530,000 jobs and returned some manufacturing operations to the United States, manufacturing employment remains low.

Growing U.S. international debt has made creditor countries more competitive. Countries with large capital reserves can more easily acquire raw materials and use export-generated surpluses to create tax and other incentives to attract foreign investment. Many Asian countries developed reserves in the wake of the 1997 Asian financial crisis to avoid relying on the International Monetary Fund or other international lenders in future crises.
Indebtedness can also harm soft power, such as diplomacy and cultural influence. For many countries as well as individuals, “creditor” spells success and “debtor” spells vulnerability. Moreover, a nation in debt must borrow still more to fund a military intervention, if raising taxes is too difficult. Debt also reduces political and economic opportunities, as evidenced by Ukraine’s initially agreeing to borrow, late in 2013, $15 billion from Russia.

Current account (international trade in goods and services, investment income, remittances and other donations)

actual for 2000-2008, estimated for 2009-14

How to recover

What can the United States do to move from record debtor to restored creditor? The deficit has resulted from both fiscal imbalance and policy failures. National policy has failed to adopt incentives to promote saving, and until recently ignored manufacturing and other productive U.S. economic assets. One consequence in 2013 was an $80 billion trade deficit in advanced technology goods, once seen as the preserve of American manufacturing.

Even when the government ran large surpluses in the later part of the Clinton administration, private borrowing persisted. Coupled with the export-led growth strategies of some of our major trading partners, these deficiencies led individuals and corporations to add to foreign borrowing. By the end of 2013, foreign governments, companies, and individuals owned
more U.S. public and private assets than their U.S. counterparts owned of foreign assets by more than $4.5 trillion.

The policy failures can be reversed. Oil and manufactured goods form the predominant part of the trade deficit. The oil imbalance can be reduced by energy conservation and the development of domestic sources of shale gas and oil.

The manufactured goods imbalance can be reduced in several ways. Already, lower domestic energy prices and higher overseas wages are lowering costs for U.S. manufacturers and raising them for competitors. Current trade negotiations with Europe and East Asia can open opportunities for U.S. manufacturers and may also address the problem of currency manipulation. Supporters of the Trans-Pacific Partnership negotiations see them as a way to push for compliance with long-standing global trade rules that assume limited government and free competition among private firms.

Increased export of services, where the United States regularly records a surplus, can also help reduce the trade deficit. This category includes engineering, design, finance, education of international students, and tourism.

- In the long run, the United States has to reduce its fiscal deficit sharply. Although there is broad consensus about this need, economists and politicians have differing opinions on how—such as by increasing taxes or reducing the size of government—and when—under what conditions of unemployment, economic growth, and so on—to proceed.

- Americans need to increase their savings rate. To promote savings, some recommend a consumption tax in place of income or payroll taxes. Others point to the example of U.S. government savings bonds, which were widely purchased during and long after World War II.

- Trade has to be brought into balance. Energy, manufactured goods, and services all have important roles to play. Ongoing trade negotiations can also help by opening opportunities for U.S. manufacturers and potentially addressing the problem of currency manipulation and other violations of international trading norms.

- A national growth and innovation strategy should focus on advanced technology goods and innovative industries and services. The National Network for Manufacturing Innovation prosed by President Obama is a step in the right direction.

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Unproductive borrowing lacks shock value but gravely threatens the future. As Charles Schultze, chairman of President Carter’s Council of Economic Advisors, once noted: “Deficits are not a wolf at the door, but termites in the woodwork.” If America does not take care of the termites, we may find tigers and dragons at our door instead.

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Hughes is the author of *Building the Next American Century: The Past and Future of American Economic Competitiveness* (Woodrow Wilson Center Press 2005). He has served as associate deputy secretary of Commerce, and president of the Council on Competitiveness, and in a number of senior positions with the U.S. Congress.